Internal Revenue Service

memorandum

CC:TL
Br4:GJDickey

date: AUG 11 1986

to: District Counsel, Chicago MW:CHI

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice in the subject consolidated cases.

ISSUES

1) Whether pursuant to the Tax Court's decision in these cases, reported at [redacted], [redacted] must include in his income amounts received by his former wife, [redacted], pursuant to an Illinois divorce court's award to her of a [redacted]% "marital property" interest in his military pension. 1002.02-00.

2) Whether the Tax Court's determination that [redacted]'s interest in the military pension is not taxable to her as alimony under I.R.C. § 71 collaterally estops the Service from determining that [redacted]'s share of the pension is taxable to her as pension income in future years. 9111.19-02; 0061.09-13.

CONCLUSION

1) Pursuant to the Tax Court's Order of [redacted], amending its [redacted], opinion, and consistent with [redacted] (hereinafter [redacted] O.M.) [redacted] should not include in his income the portion of the pension payments received by [redacted].

2) The Service is not collaterally estopped from asserting that [redacted]'s share of the military pension is taxable to her as pension income.

FACTS

The subject cases involve [redacted]; the calendar and taxable year during which [redacted] were divorced. The Judgement for Dissolution of Marriage incorporated the parties' oral agreement that [redacted] receive one-half of [redacted]'s monthly

military retirement check regardless of whether she remarries. The Judgement specified that "[t]he government retirement check shall be the gross check minus only the taxes due on said amount." In [redacted], [redacted] received $[redacted] as result of her interest in the military retirement benefits. [redacted] did not include this amount on her return on the assumption that it represented a nontaxable division of property. [redacted] included the entire amount of the retirement checks in his income but deducted the amount paid to [redacted] as alimony. The notice of deficiency issued to [redacted] asserted that the amounts she received were taxable alimony. [redacted]'s notice of deficiency took the inconsistent position that the payments to [redacted] were not alimony and therefore could not be deducted. Nevertheless, on brief, the Service argued, consistent with the [redacted] O.M., a third position, that being; the amounts [redacted] received were includable in her income, not because they were alimony, but because they represented her interest in the military retirement benefits and were thus taxable to her as pension income under I.R.C. § 61.

The Tax Court concluded that this argument would unfairly prejudice [redacted]'s case and balked at considering it. Nevertheless, consistent with the Government's brief and [redacted]'s contentions, the Court held that [redacted]'s interest in the government retirement benefits was part of an equitable division of property and thus was not taxable as alimony. Such amounts are not includable in [redacted]'s gross income under I.R.C. § 71, nor are they deductible by [redacted] under I.R.C. § 215. [redacted]. Although the Court originally did not address whether [redacted] must include the total amount of the retirement checks in his income, it amended its opinion on [redacted], by adding; "[t]he portion of the pension payments received by [redacted] pursuant to the Judgement shall not be included in [redacted]'s income."

DISCUSSION

The Tax Court's order of [redacted], specifying that the amounts [redacted] received are not to be included in [redacted]'s income, is generally supported by the legal analysis set forth in the [redacted] O.M. and the Government's argument on brief. All parties seem to agree that "state law creates legal interests but the federal statute determines when and how they shall be taxed." United States v. Mitchell, 403 U.S. 190, 197 (1971). Nevertheless, even though under this principal substantive property rights as determined by a state's highest court could be viewed as binding on the Service with respect to such interests, the Service has repeatedly attempted to apply Federal principals in order to determine for itself whether the interests amount to co-ownership so as to qualify as a non-taxable division of property. See [redacted], O.M. 18286 I-97-75 (Oct. 1, 1975). In these efforts, the Service has frequently looked to the interests discussed by the Supreme Court in United States v. Davis, 370 U.S. 65 (1962). The Service simply does not consider itself bound to uncritically

accept "co-ownership" characterizations, even when applied by the highest state courts. See [redacted] O.M. supra at 8. Recently, the Tax Court has made its views on this line of thought unmistakably clear. Adopting the 10th Circuit's reasoning in Collins v. Commissioner, 412 F.2d 211 (10th Cir. 1969), the Court noted that in Davis, where the state's highest court had not made a determination of the relative property rights, the Supreme Court considered general characteristics of co-ownership in order to determine whether the wife was a co-owner under state law. Were the state's highest court has already determined co-ownership, however, the Court noted "there is no need to search state law for indications of other factors that might signify the nature of the wife's property interest." Collins supra at 212, quoted in McIntosh v. Commissioner, 85 T.C. No. 4 (July 16, 1985).

Although this view has yet to be embraced by the service, a more pragmatic approach to litigation is clearly warranted. This need is reflected in the [redacted] O.M., which points to the "plethora of complex and at times seemingly inconsistent decisions" which followed Davis. Despite potential problems of consistency (See eg., [redacted], G.C.M. 37085, I-362-7 (April 8, 1977), and [redacted], O.M. 18286, I-97-75 (Oct. 1, 1975), the [redacted] O.M. declined "to attempt to create order out of chaos in this area" and concluded that under the Illinois "marital property" statute the division in this case is of "co-owned property and is not a taxable transfer by the husband in discharge of a marital obligation, under United States v. Davis, 370 U.S. 65 (1962)." [redacted] O.M. supra, at 1. 1/

1/ Although of no precidential value, a recent letter ruling supported this view in analogous circumstances: "[i]n State A, a noncommunity property state, state law provides that vested military retirement pay is marital property. An examination of state law reveals that a spouse's contribution as a homemaker is to be considered in addition to any financial contributions in the acquisition of marital property. State A court cases conclude that a spouse acquires a vested interest in the property accumulated during the marriage, and that this interest vests upon dissolution of a marriage. Because state law determines the character of any interest and rights in property, a spouse's right in her husband's property granted to her by State A law constitute a cognizable form of co-ownership." (emphasis added) [redacted], Index No. 0071.07-00, CC:IND:I:1, 3-5G9650. The ruling concluded that the interest in retirement pay awarded to the wife was therefore a nontaxable division of co-owned property. While the ruling recites that the Service looks to state law in light of the Davis criteria to determine substantive property rights, it seems such criteria played little part in the ruling's analysis in light of its general deference to state law.

In our opinion, the [redacted] O.M. takes a logical approach. The litigation risks associated with this issue weigh heavily against continued efforts to challenge co-ownership determinations entered by state courts in conformance with state law as interpreted by the state's highest court. Neither the Tax Court nor the Federal courts of appeal can be expected to now accept any challenge by the Government on this basis. See McIntosh v. Commissioner, A.O.D. (April 28, 1986). Accord, Kenfield v. Commissioner, No. 83-1968 (10th Cir. Feb. 10, 1986); Serianni v. Commissioner, 76 F.2d 1051 (11th Cir. 1985); Boucher v. Commissioner, 710 F.2d 507 (9th Cir. 1983); Imel v. United States, 523 F.2d 853 (10th Cir. 1975); Collins v. Commissioner, 421 F.2d 211 (10th Cir. 1969); McIntosh v. Commissioner, 85 T.C. No. 4 (July 16, 1985); Cook v. Commissioner, 80 T.C. 512 (1983), affd. without published opinion, 742 F.2d 1431 (2d Cir. 1984). Further, in light of I.R.C. § 1041 enacted under the Tax Reform Act of 1984 and which provides in part that no gain or loss shall be recognized on a transfer of property from an individual to a former spouse incident to a divorce, the Government should no longer be faced with litigants seeking to avoid Davis taxable event treatment. The new litigants will be former spouses disposing of property and claiming increased basis as of the date of divorce pursuant to Davis. See e.g. Serianni v. Commissioner, supra. The potential for whipsaw in non-community property jurisdictions where the Service's attempted application of Davis principals has been rejected is obvious. Greater acceptance of co-ownership characterizations where supported under state law thus makes good sense in future litigation. Finally, as noted in the [redacted] O.M., although I.R.C. § 1041 is not directly applicable to this case, the Joint Committee on Taxation specifically stated, as part of its rationale in support of it, the general proposition that it is "inappropriate to tax transfers between spouses." This may reflect an increasingly hostile climate to Federal government challenges to state co-ownership characterizations that can be expected to grow as I.R.C. § 1041 becomes more familiar to the courts.

The subject case is a good example of why acceptance of a state's characterizations of co-ownership, particularly in regard to a "marital property" military pension, makes good sense.

Although the Court in the subject case did not discuss its reasoning in detail, it clearly held that the division of the military pension constituted part of a division of marital property. Citing In re Marriage of Fairchild, 442 N.E. 2d 557, 561 (1982), the Court elaborated on the nature of [redacted]'s right by noting that Illinois views an individual's interest in a pension right as a right in property and not as a right to future income. As detailed in the [redacted] O.M., pension rights in Illinois, to the extent that they are earned during the marriage, are marital property in which each spouse has an

apportionable ownership interest. Although this view was jeopardized by the Supreme Court decision in McCarty v. McCarty, 453 U.S. 210 (1981), (holding that a state could not divide a non-disability military retirement pension as marital property), the Tax Court in the subject case held that the doctrine of res judicata rendered the McCarty decision inapplicable. Moreover, the Court noted that the Uniform Former Spouses' Protection Act, Pub. L. 97-252, 96 Stat. 718, 730-38 (1982) effectively legislated McCarty out of existence in providing that Courts may treat disposable retirement pay as either the property of the ex-service member, or as the property of both the ex-service member and his or her spouse. The legislation applies retroactively to before the McCarty decision. In light of such specific statutory authority it would indeed be difficult to challenge a "marital property" state's characterization of military retirement pay as co-owned.

Since under state law it appears that the Government has no basis for challenging characterization of [redacted]'s interest as one of apportionable ownership, and, a basic principle of tax law is that income is taxable to the owner of the property (See Helvering v. Horst 311 U.S. 112 (1940), it follows that [redacted], who does not own [redacted]'s portion of the retirement pay, may not be taxed on such portion and [redacted] should be. As noted in the Government's brief, gross income consists of income "from whatever source derived" and includes pensions. I.R.C. § 61(a)(8) and (ii); Treas. Reg. §§ 1.61-2(a) and 1.61-1(a). Pensions include military retirement pay. Zell v. Commissioner, 47 T.C.M. 1371 (1984); Howell v. Commissioner, 42 T.C.M. 1564 (1981). Accordingly, in community property jurisdictions the former spouses are each taxed on their respective shares of the pension. Lowe v. Commissioner, T.C. Memo 1981-350, Accord, Rev. Rul. 63-169, 1963-2 C.B. 14; Rev. Rul. 69- 471, 1969-2 C.B. 10. As of the date of divorce, the former spouses in community property jurisdictions and marital property jurisdictions both have the status of co-owners. The tax result should be no different. Unfortunately, as earlier noted, the Tax Court did not rule on this contention. Nevertheless, insofar as the Court held that the payments constituted a division of property and that [redacted] is not liable for tax on [redacted]'s portion, the Court's findings comport with our analysis.

In regard to the issue of withholding, we subscribe to the position taken in the [redacted] letter ruling, that the Department of Defense should withhold on the entire amount of the military retirement pay and then each spouse should be given an appropriate credit under I.R.C. § 31 for their respective portion of the amount withheld. We think that this also comports with the language and intent of both the divorce court and the Tax Court. This aspect of the issue is yet to be clearly resolved, however.

The final issue raised in this case is whether the Service is collaterally estopped by the decision from determining that amounts [redacted] receives are taxable to her as pension income under I.R.C. § 61. We first note that in regard to the year at issue, the Service is restricted from determining any additional deficiency against [redacted] in the statutory notice even if it expressly asserted that she is taxable on pension income under I.R.C. § 61. See I.R.C. § 6212(c). Also, raising the issue via an amended answer is impractical at this point. Tax Ct. R. 41. As to subsequent tax years, we agree with your conclusion that the Service may determine deficiencies with regard to [redacted] on the pension income theory for years after [redacted]. A prior action estops only those issues upon which a finding or verdict was rendered. Commissioner v. Sunnen, 333 U.S. 591 (1948), rev'g 161 F.2d 171 (8th Cir. 1947) stands as ample support for this proposition and has been repeatedly cited as authority on this issue in the Office of Chief Counsel. See In re: Collateral Extoppel - Impact of Supreme Court Decisions in Mendoza, Stauffer, and Hoover, LGM 7059.1 CHG 90 (Jan 17, 1986) for a fuller discussion of collateral estoppel. The pension income theory was simply irrelevant to the Court's determinations in the subject case for [redacted] and no legal bar exists to its application for later years.

In conclusion, we recommend that deficiencies be determined as to [redacted] under the pension income theory for her share of the pension checks, crediting her with one-half the Federal tax amounts withheld. Similarly, [redacted] is taxable on his share of the checks and should be credited with one-half of the Federal tax amount withheld. He may not be credited with amounts withheld that are attributable to [redacted]'s share. We agree with you that the best course of action here is not to appeal the present loss but to pursue Service interests in post-[redacted] deficiencies against [redacted], recognizing that we will have to overcome a collateral estoppel argument if we hope to prevail on the merits. Additional questions may arise as the matters discussed herein are developed. Please feel free to call Gordon John Dickey at 566-3345 for informal technical advice as needed.

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